Chronology of a potential default

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An ordinary Ukrainian's vocabulary has been enriched recently with a new term: default , understood as failure to act or failure to pay up one's debts. According to the Annual Address of the President of Ukraine to its parliament, by the end of 1999 Ukraine's foreign debt had exceeded US$ 12.6 billion, or 54.2% of its GDP. In 1999, including the devaluation of the national currency, hryvnya, the foreign debt had grown from 41.8% of the GDP at the beginning of the year to 54.2% of the GDP in late December 1999, though the 1997 figure had been substantially smaller (22.9% of the GDP).

We have approached the threshold beyond which - and the international experience has proved that - a country loses practical ability to get out of the debt pit and turns into a chronic debtor, the President admitted. The bulk of the payment is to be made within 2000-2001. According to the President's Address, as a result, the demand for additional loans will continue to grow, while the ability to get them will be increasingly narrowed. Loans will become increasingly expensive, respectively. This enhances the threat not only of an external default, but that of the loss of Ukraine's ability to pursue a policy that would correspond with its national interests. In 2000 Ukraine has to repay over US$ 3 billion, including the payment of US$ 700 million due in February-March 2000. The country owes about US$ 900 million to the IMF alone. The new budget, approved by the Ukrainian parliament in mid-February, limits the state domestic and foreign debts that may be accumulated by January 1, 2001 to UAH 25,710.517 million and the equivalent of US$ 12,492.214 million, respectively. Currently the National Bank's hard currency reserves stay at only US$ 1.1 billion, which suggests that even if Ukraine's foreign debts are restructured, the country will hardly be able to pay the creditors without further foreign loans.

Debts must be paid. Both Ukraine's Prime Minister and the President have explicitly stated so. Yet, notwithstanding the new - for Ukraine - style to name at least some things by their proper names, there is an obvious effort to avoid mentioning the word default . Meanwhile, the dynamics of the debts since the beginning of this year has left few reasons for optimism.

In early January 2000, Secretary of the National Security and Defense Council Yevhen Marchuk named default as one of key threats to Ukraine and urged to analyze the anatomy of threats and develop blocking techniques. To minimization of the state finance due to the payment of foreign debts which, as everybody knows, are taken for some time but have to be repaid for good, we should respond with a perfect investment climate, he argued. Yet, a perfect investment climate in Ukraine remains a thing in the future...

At about the same time Prime Minister Victor Yushchenko announced that the IMF mission would come to Ukraine on January 12, 2000, and the cooperation within the EFF program would be resumed following the results of its visit. According to Mr. Yushchenko, a factor that would contribute to renewal of funding would be a package of ambitious bills, developed by the government to be submitted to the parliament together with the draft 2000 budget, as the government does not want the central authorities to make new debts .

An opinion on foreign borrowings was offered by Victor Pynzenyk, MP: the country must gradually get out of the loop of the debt: no borrowings, except from the [International] Monetary Fund, for they are long-term; but their amount should be smaller than the debt service fees. These are urgent things linked to maintaining economic stability of the state. In his view, the issue of debt restructuring will be particularly acute: in principle, no government would be able to solve the problem in the forthcoming year. But will the [debt] restructuring [offers] be accepted? It will, if it becomes clear that domestic decisions are directed at preventing the debt situation from occurring again. Victor Pynzenyk was among the first Ukrainian politicians who publicly mentioned the possibility of default and articulated his view on possibilities to avoid it. Everything depends on whether [positive] decisions are made on bills proposed by Victor Yushchenko. Potentially we have a chance to maintain the [exchange] rate, avoid the default and create the foundation for economic growth. But do we have sufficient political conditions for that?.. I would still keep my reservations about the almost constitutional majority that voted for Victor Andriyovych [Yushchenko]. [I am] more concerned about further political support for the new Prime Minister's decisions...

Experts of the 2nd European Department of the International Monetary Fund arrived to Ukraine on January 11, 2000 and declared the intention to continue negotiations with the Ukrainian government on resuming the EFF. Specifically, the IMF mission came to discuss the issues of the foreign debts, Ukraine's new privatization program, compliance with IMF's demands that limitations on agrarian product exports be abolished and that gas and electricity be paid by Ukrainian consumer with money only. Meanwhile, the Ukrainian parliament's committees and factions continued debating the draft 2000 budget. According to then deputy head of the Budget Committee Oleksandr Turchynov (the Batkivshchyna faction), he would not call the document Victor Yushchenko's draft budget. Both the [draft] budgets [submitted] by [previous] Prime Minister Valery Pustovoitenko and this one are draft budgets of Minister of Finance Igor Mitiukov. [I am] not sure that Victor Yushchenko, within two weeks in his new position, could have clearly developed his own view on regional and national problems.

On January 15, 2000 Victor Yushchenko announced he was in the process of negotiating the forms of servicing Ukraine's foreign debts. He added that Ukraine took the full responsibility for paying the interest on the loans. As the debt for Russian gas comprised a substantial portion of Ukraine's overall foreign debt, Victor Yushchenko stated productive negotiations were in process with the Russian Gazprom and the Itera company, the supplier of the Russian gas to Ukraine. According to Yushchenko, the Russian party was prepared to demonstrate understanding, indications of which had been made during the visit of leaders of the Russian gas business to Ukraine. The Prime Minister also added that the 2000 budget envisaged full service of expenditures related to paying up the loans, [and] the interest on the funding received , and that the government had procedurally settled all issues linked to servicing the foreign debt in 2000 and had started bilateral negotiations with creditors. The forms of response and relevant reaction of the Ukrainian party to the 2000 debts will be adequate, and [it will be] identified during the negotiations, Yushchenko said, assuring that in 2000 Ukraine will treat the debt positions responsibly . Stating that the volume of debts to Western creditors was rather serious , Victor Yushchenko explicitly named the cause: for several years the authorities had spent more than the country could earn .

Speaking to leaders of diplomatic missions in Kyiv on January 18, 2000, President Leonid Kuchma argued that exceptionally favorable conditions for the pursuit of radical reform have been created in Ukraine. There is a clear program of action and the government that is able to implement it. There is the wish and there is the will for that , but today, as never before, we need international support [of] our partners, international institutions . The list of indications of support expected by the Ukrainian authorities included restructuring of Ukraine's foreign debts. Urging to demonstrate such support, Kuchma argued that a stable, economically strong Ukraine is needed and good not only for its people, but also for Europe [and] the world as an important factor of stability, security and peace.

On January 24, the national media quote the President's spokesman Oleksandr Martynenko as saying that Leonid Kuchma and head of the IMF's Ukraine mission Mohammed Shadman-Valavi had concluded the issue of Ukraine's foreign debts could be resolved. The adoption of the 2000 state budget was named as one of the conditions of further cooperation between the IMF and Ukraine. According to Martynenko, Ukraine complied with practically all requirements of the IMF, including abolishing housing and communal service subsidies to the population. The media also quoted Mohammed Shadman-Valavi as stating there was hope that the agreement between the IMF and the government of Ukraine would be achieved within a few weeks and that the agreement was conditional on both the government's and the parliament's final positions on the 2000 budget, the commitment to the pursuit of the administrative reform. The IMF mission head was also quoted as saying that agrarian and energy reforms were critical for restoring Ukraine's economic performance. Yet, responding to the question about chances that Ukraine's foreign debts would be restructured, he stated that the IMF was not involved in the talks.

On January 20, 2000 Ukraine failed to pay US$18 million for Eurobonds due to mature in February 2001 issued by the Chase Manhattan Bank Luxembourg S.A. Commenting on the fact a few days after, Victor Yushchenko argued he was sure that Ukraine would manage to prevent default. However, after the bonus period for the payment expires, holders of the bonds may initiate the procedure of formally announcing default to Ukraine and demanding the payment in full. Negotiations with creditors - international financial institutions, clubs and individuals - about conditions of servicing Ukraine's debts in 2000 were pursued, according to Yushchenko, in an active mode . Although no claims about the overdue payments had been made by that time, we cause delay to implementation of international programs, Yushchenko said. Hence, Ukraine's hopes relied mainly on the support of the IMF that was seeking to carry out its global idea of solidarity responsibility for accumulated debts of private creditors and lenders. Yet, at the end of January - early February 2000, the problems received a new unexpected turn. Accusations of misuse of IMF loans by Ukraine, published by the Financial Times with the reference to Ukraine's former Prime Minister Pavlo Lazarenko, grossly hindered the Yushchenko government's efforts to secure restructuring of Ukraine's foreign debts. Although Yushchenko argued he had managed to reach agreement with several Western banks about restructuring of the Ukrainian

bonds, the Dow Jones agency publicly argued that the creditors, seeking to secure the most favorable conditions for the debt restructuring, might threaten Ukraine with default. According to the Dow Jones, the London-based Standard Bank informed the Ukrainian government it possessed enough bonds to officially announce default to Ukraine. Since the debt restructuring was possible only provided at least 75% of bond holders agree to it, and since the Ukrainian government, reportedly, had secured agreement of half of its creditors, it looked like the Standard Bank, controlling about 25% of the bonds, was seeking to bargain the best conditions. According to the Financial Times, the investors would lose about 40% of their potential profits, which in turn would prevent new bonds from raising the rating of Ukrainian debts from the current 30% to 60% of their nominal value.
On January 21, 2000 it was announced that after Prime Minister Yushchenko's meeting with chairman of the board of the Gazprom Rem Vyakhirev Russia had agreed to restructure Ukraine's gas debt provided the payments were completed within 2000. The mechanism of clearing the debts was specified in the protocol On Regulating Relations , under which Ukraine agreed to pay up its gas debts with Russian bonds, goods worth the total of US$ 500 million and money. It was also announced that the Gazprom's potential participation in privatization of Ukrainian enterprises had not been discussed during the negotiations.
On January 23, First Vice Speaker Victor Medvedchuk made an optimistic statement that Ukraine will endure even the refusal to restructure the foreign debts , and added that the 2000 state budget had been formed to include that potential option. At about the same time President Leonid Kuchma, speaking at the Institute of Further Qualification of the Ukrainian Academy of State Governance, stressed the need for political stability in the state and announced it was hindered by the ongoing confrontation between the parliament and the government that complicated the solution of the problem of debts to the IMF and Russia due to the delayed adoption of the 2000 budget. To eliminate the hindrance, the referendum, scheduled to take place on April 16, 2000, was seen as an effective method of cooling some heads and bringing Ukraine to the way of constructive legislation.
Kuchma's - not Yushchenko's! - opponents, primarily leader of the traditional Socialists Oleksandr Moroz, predicted that default was inevitable. According to Moroz, default at the level of Ukraine is the colossal jump of prices, communal fees, devaluation of hryvnya . Critical comments were also made by some representatives of the new pro-Kuchma parliamentary majority. First Vice Prime Minister of the previous government Anatoly Kinakh - who had just established a party of his own on the basis of the Ukrainian League of Industrialists and Entrepreneurs - announced that Ukraine's total debts had increased by almost 7% in 1999 and reached UAH 220 billion, but the measures taken by the government resemble slogans, borrowed from the IMF, and do not take into account the systemic nature of the payment crisis that have stricken the Ukrainian economy . Speaking at a press conference on January 26, Anatoly Kinakh focused on a minor problem: Ukraine's obligations regarding its foreign debt . The amount to be paid reaches 40 to 45% of the revenue part of the national budget. I seriously worked for restoring the cooperation with international financial institutions and for the debt restructuring. None of the previous governments had worked in such difficult conditions , he argued, though adding that there is no sense to agree to every condition, to make every step following the IMF order. Sometimes they do not correspond with objective economic laws.
The President's Annual Address to the parliament, alongside with classic causes of Ukraine's economic problems, referred to serious drawbacks and miscalculations in the financial, monetary and currency policies of the government (the Ministry of Finance) and the NBU [i.e., National Bank of Ukraine]; artificial financial pyramid that had been formed in 1996-1998, not always qualified actions of fiscal and banking bodies in pursuing the policy of domestic and foreign borrowings and servicing them. Given these circumstances , the government now faces the task to take effective measures to ensure servicing the current debt obligations of 2000 and 2001, and develop, jointly with the Verkhovna Rada and the NBU, a coordinated state strategy on issues of foreign borrowings and ways of gradually reducing them. The task was to reduce the proportion of the foreign debt from 58% of the GDP in 2000 to 54% in 2002 and 46% in 2004. The urgent measures to be taken to solve that key problem of the state's economic policy for the next five years included continuing, in 2000-2001, cooperation with the IMF within the EFF program, as well as [cooperation] with the World Bank and the European Bank for Reconstruction and Development. Providing for complete transparency of relations between Ukraine and international financial institutions ; legal prohibition to use the state's foreign loans for financing current budget expenditures. Rejection of the state's [practice] of receiving expensive short-term loans ; reaching agreement between the government and the National Bank about review, for the long term, of conditions of servicing and payment of short-term state bonds maintained by the NBU ; and identification and implementation of procedures of indirect exchange of state assets for foreign debt obligations .

The IMF mission led by Mohammed Shadman-Valavi worked in Kyiv on February 15-22, 2000. It was expected that if the mission's conclusions were positive, Ukraine would be able to receive the next, US$ 300-million tranche of the IMF loan at the end of February or in early March. To date Ukraine has received US$ 960 million of the anticipated US$ 2.6 billion EFF loan, but the disbursement of funds was suspended in September 1999 due to Ukrainian government's failure to comply with a number of IMF's requirements.

On February 16, 2000, upon returning from London where he had made the first official presentation of the program of restructuring Ukraine's commercial foreign loans to foreign investors, Victor Yushchenko stated that Ukraine's foreign obligations were to be re-arranged within the next 30 days and that Ukraine would negotiate the issue with its key partners in Zurich, Frankfurt, Madrid and New York. According to Yushchenko, the government expected to re-arrange 85% of Ukraine's foreign obligations, and Ukraine's proposed conditions for restructuring the debts were viewed by investors in London rather optimistically .

On February 24, upon completing negotiations with First Vice Prime Minister of the Russian Federation Mikhail Kasianov, Victor Yushchenko announced that by February 1, 2000 the verified total of Ukraine's gas debt to Russia had been US$ 1.410 billion, and that the debt had totaled US$ 1.279 billion as of January 1, 2000. However, some Ukrainian media, referring to Deputy Minister of Finance Serhiy Makatsariya, quoted different figures: Ukraine's verified state debt to Russia currently stays at US$3 billion, including US$ 2 billion of government loans received in 1992-1993 and US$ 1 billion owed to the Gazprom for the 1994 supplies of gas. According to Mr. Makatsariya, the figures were quoted in the protocol of verification of state and corporate debts between Ukraine and Russia, signed by representatives of the two states' Ministries of Finance as a result of a session of s special working group. Russia's debt to Ukraine is about 1,000 times less: it amounts to only US$ 3.9 million. The Russian government would make a decision that would support the Ukrainian government's efforts to restructure its foreign debts, announced Mikhail Kasianov. He said that would also involve Russia's support for Ukraine as a member of the Paris Club should Ukraine appeal to the club for restructuring its foreign debts. Furthermore, said Kasianov, the Russian government would lend Ukraine a supportive hand in restructuring its debts to Russia, her largest creditor . Probably, the price of such an outcome will be the development of a new ideology of the trade policy between the two countries, so that to remove all barriers that currently exist in the customs and taxation spheres. According to Victor Yushchenko, a special working group would present the scheme of optimizing the trade and customs regime to representatives of the Ukrainian and the Russian governments within two weeks.

First deputy head of the Russian government Mikhail Kasianov sees a rather simple way of settling the issue of debts: Russia insists that Ukraine gives away some of its state property to cover for portions of the gas debts, and will soon present a list of enterprises shares of which can be used as the method of payment. The list includes, for instance, shares of the Mykolayiv Alumina Plant. Commenting the information, Victor Yushchenko stressed again that the option of covering the gas and energy debts with Ukrainian assets had not been discussed at the recent Ukrainian-Russian negotiations, and that the gas debts would be documented taking into account what the Russian party owes Ukraine.

On March 6, 2000 Victor Yushchenko announced he was sure of successful restructuring of the foreign debt, expected to have been finalized by March 15, but did not give any details as to the proportion of creditors who had agreed to change their bonds for new ones. He added that foreign funding might be resumed in April 2000 if the [IMF's] Board of Directors approved a three-year EFF program for Ukraine.

Serious hopes were vested in Victor Yushchenko's visit to Washington D.C. planned for March 14-16, 2000 but suspended due to the accident at the Barakova coal mine on March 11, 2000, leaving over 80 miners dead. The government expected that during the visit Mr. Yushchenko would manage to solve the issue of resuming the IMF funding. Currently the government is working hard to implement the IMF recommendations formulated in the course of the IMF mission's visit to Ukraine on February 15-22, 2000. First Vice Prime Minister of Ukraine Yuri Yekhanurov told the press that putting the issue of resuming the EFF loan to Ukraine on the IMF board's agenda had been delayed by the audit of the NBU and some brought-in external problems . According to Yekhanurov, Yushchenko's high moral authority would enable him to solve many problems in Washington , and the volume of the first tranche of the loan after the funding is resumed is not critical for Ukraine . After all, according to Yekhanurov, the point is not [to receive] a certain amount of money. The principle thing is to send all our creditors a signal: Ukraine is not an open zone and it can be worked with. Earlier on, leaders of the Ukrainian government were similarly confident that the IMF would approve resuming the EFF program by March 15, 2000, the deadline for the exchange of bonds worth about US$ 2.6 billion due to mature in 2000-2001 for seven-year Eurobonds subject to amortization. Later on, it became clear that the IMF funding would not be resumed at least until after the NBU audit, performed by the PricewaterhouseCoopers and expected to last till March 31, 2000.

On March 7, 2000 the NBU announced that the audit had found no evidence of operations resembling, in any way, the one alleged to have taken place by the Financial Times articles, according to which in 1997-1998 the NBU had transferred about US$ 600 million of its currency reserves through the Credit Suisse First Boston, seeking to exaggerate the size of its hard currency reserves but concealing the risky operations from the IMF. A day before the results of the first stage of the NBU audit was announced, the World Bank officially demanded that its transactions to the Ukrainian government be also included in the audit. All in all, Ukraine received US$ 1.8 billion from the World Bank within several loan programs.

Meanwhile the government has started preparing the West to the thought that the West might be morally responsible for a possible default and related collapse of the market reform efforts if Ukraine's foreign debts are not restructured. Minister of Economy Serhiy Tihipko, seen by the West as one of the few strong advocates of market reform in Ukraine, was chosen to send the warning to the international community. Speaking at a press conference on March 9, he argued that the government's radical reform program of action had been continuously challenged by disruption due to the very acute problem of payments to be made to foreign creditors. According to Tihipko, if the government fails to come to terms with the IMF about further loans, the government's good intentions are doomed to remain on paper. Today this is of critical importance for us, because, as you know, without the support of the International Monetary Fund it is impossible to restructure our debts completely, stressed Tihipko. He went on to describe a very attractive alternative, directly linked to the approval of the government's new program of action. If we adopt this program, implement it, Ukraine will become a member of the World Trade Organization, conditions will be created for Ukraine's associated membership in the European Union, a zero-deficit budget will be formed in 2000, the growth of debts for government's loans and state guarantees will be successfully constrained, which would lead to reduction of the country's debt burden, the stability of prices will be maintained; land will be privatized, and a developed infrastructure of the agrarian market will be created, allowing to increase agrarian output by 1.6% in 2000 and 4% in 2004, he said.

Yet, while the government's efforts are focused on solving at least part of the foreign debt problem or avoiding the default, domestic debts continue to grow. By February 10, 2000 wage arrears has reached UAH 6.5 billion, or 1.3% more than during the previous months. UAH 5.8 billion of the above amount are wage arrears for previous years, while the rest, UAH 672 million, is the new debt accumulated in January 2000. So far the word default is used primarily in the context of relations with foreign creditors, but the sad dynamics of the domestic debt suggests that the ranks of those willing to announce the default to the authorities may grow substantially soon.